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The unsung benefits of *wholesale* competition to electric utility customers who forgo *retail* competition

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A B S T R A C T

Electricity deregulation came in two parts: wholesale and retail. While wholesale competition has lowered system costs, the verdict on retail choice is less certain. Some customers enjoying the benefits of competition in certain retail choice states are, ironically, those who do not choose a third-party supplier. As can be seen in case studies from Illinois and Maryland, these 'default' utility customers benefit from use of best practices in competitive procurement

The price of monopoly is upon every occasion…the highest which can be squeezed out of the buyers, or which it is supposed, they will consent to give: the [natural price, or the price of free competition] is the lowest which the sellers can commonly afford to take, and at the same time continue their business. – Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*.

1. Introduction

Electricity deregulation came in two parts: wholesale and retail. Wholesale deregulation meant the separation of generation of electricity from its transmission and distribution. Many suppliers of wholesale generation could compete to supply electricity over the regulated transmission and distribution lines of the utilities. Retail deregulation, or "retail choice," meant that end users of electricity – residential, commercial, and industrial customers – could directly choose their supplier of generation and electricity services.

In both instances, deregulation was supposed to harness the power of competition to lower costs and produce prices that are closer to the "price of free competition" noted by Adam Smith, rather than the monopoly price. Give buyers the right to choose, the theory goes, and suppliers will compete and lower overall costs. At the wholesale level, this has largely been the case: there is considerable evidence that regional power markets – like PJM, among others – have used the power of competition to lower system costs. At the retail level, this may be less certain. In the view of some energy economists, the promised benefits of retail choice are "partly real and partly illusory.[2];

Typically, most discussions of retail choice culminate in a comparison between electricity rates in retail choice states and those under traditional retail regulation. But there is a set of customers – sometimes ignored in the policy debate – that are enjoying the benefits of competition and, ironically, this set of customers has chosen *not* to exercise their right under retail choice to select a so-called third-party, competitive supplier for their power. These are the "default" utility customers in retail choice states who, by virtue of not selecting a competitive retail supplier, receive their power from their local utility, which is obligated to supply such customers.

It would appear that these default utility customers, by their decision to forgo a third-party supplier, would be left behind by the virtues of competition, but for some of them the opposite is often true: through harnessing *wholesale* competition for customers who forgo *retail* competition, those customers are enjoying its benefits (and may not even be aware of it). These benefits are the result of some state laws and regulations that require the utilities to conduct rigorous competitive procurements to supply those default customers. And as explained below, those select states are seeing the benefits of competition play out in these competitive procurements, which are helping to keep prices and rates competitive.

2. Lay of the land

So which are the select states that quietly enjoy the benefits of competition for their default utility customers? Recall that, of our 50 states, only 14 plus the District of Columbia currently have some form of retail choice. Fig. 1 shows those states in green; red states are those

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[2] Christensen Associates Energy Consulting, "Retail Choice in Electricity: What Have We Learned in 20 Years?" Feb. 11, 2016, page 66.

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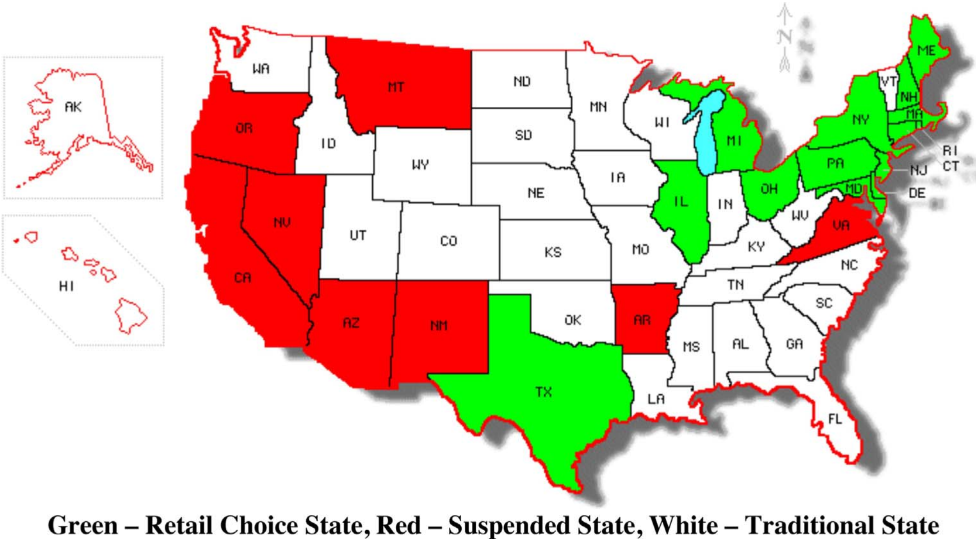

Fig. 1. Instances of retail choice.
Green – Retail Choice State, Red – Suspended State, White – Traditional State
Source: CAEC Report, Fig. 1.

that previously had retail choice but suspended or repealed its use Fig. 1.[3]

Digging deeper, of those 15 jurisdictions, not all offer retail choice to all of their customers. Michigan, for example, caps customer participation in retail choice at 10% of the utility's sales in the previous year.

In states where all jurisdictional customers are eligible for retail choice, the method for securing service for default utility customers – again, customers who do not choose a third-party supplier – can vary. In some states, like most of those in New England, the utilities typically solicit offers to supply default utility customers, but do not always use best competitive procurement practices; for example, the utilities conduct the solicitation of offers on their own and apply a series of quantitative and qualitative measures to pick winning suppliers. This can minimize transparency and lead to potentially unfair outcomes, which, in turn, can limit participation by interested suppliers, further limiting competition.

That leaves just a handful of states that use best practices in soliciting service for default utility customers, including New Jersey, Ohio, Illinois, Maryland, Delaware, Pennsylvania, and Washington, DC. These states use a series of best practices that include:

1. Use of a request for proposal format that uses a broad notice to solicit interest. This encourages greater participation.
2. Solicitation of a standardized product using standardized contracts, which allows for price-only evaluations. This helps enhance transparency.
3. Engagement of independent oversight by an administrator and/or monitor. This enhances the credibility of the procurement auction, ensures bidders are treated and evaluated the same, and that there will be no undue preference given to the utility or its affiliates.
4. Clear rules governing participation by utility affiliates, including utility codes of conduct that govern interaction by the utility with its generation-owning affiliates.
5. A transparent review process by the state public utility commission that allows for scrutiny by commissioners and staff before approval is given.
6. Unregulated utility affiliates participate in the utility procurements under the same rules as non-affiliated suppliers.

Use of such best practices helps lead to transparent results that provide suppliers with certainty that they will be treated like all other bidders, including utility affiliates. This, in turn, creates a virtuous cycle in which suppliers seek to participate, delivering with them the benefits of increased competition.

To best illustrate the benefits of wholesale competition for default utility customers in retail choice states, I present two case studies. But before proceeding, it is important to frame the discussion properly.

This article is not about whether retail choice is a good policy, or if retail choice is delivering benefits to ratepayers. Importantly, it is not about whether third-party suppliers are beating the incumbent utility in the price of power. Often, such comparisons are not apples-to-apples; third-party suppliers can offer customers a variety of options in signing up for service that may not be directly applicable to utility service. And while some have noted instances where default-service customers pay less than customers who buy service from third parties,[4] this article will stay agnostic on that point.

Instead, this article is about whether customers who do not choose a third-party supplier are missing out on the benefits of competition, and whether they are at the mercy of their utility in paying for service. The answer, in several states, is no. Thanks to the use of well-designed auction procurement mechanisms, such customers get their power from a variety of suppliers, chosen through competition on price.

3. Two case studies

To demonstrate the success of default service procurement auctions in retail choice states that use best practices, I provide two examples in this section: Illinois and Maryland. While employing similar auction designs that use similar best practices, the two states differ in two key ways. First, Illinois procures its electricity products – such as energy, capacity, and renewable energy credits – in separate procurement auctions. Maryland, on the other hand, procures them all at once as a "full requirements" product. Second, the information that is released publicly regarding the results of the procurement auctions differ.[5] In Illinois, the average winning prices for each product and the winning bidders are made public, while the number of bidders and the winning shares are not. In Maryland, all the bidders, winners, and winning shares are made public, but not prices. These differences allow for different analytical approaches to test the competitiveness of the results. In Illinois, I focus in particular on prices, while in Maryland, I focus more on participation.

[3] Christensen Associates Energy Consulting, Fig. 1.

[4] CAEC Report, page 61.

[5] This is to protect the integrity of the procurements. All data used in this article is public.